InFocus

Irish Life's view on investments

Inflation on the prowl in 2011

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Irish Life

InFocus
A summary of our views

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This document should not be relied upon for individual investment advice. Please contact your Financial Adviser for advice on your own investment needs.

Inflation on the prowl in 2011

- Equities should perform reasonably well in 2011, but will face a number of headwinds – in general, we believe quality large cap companies look attractively valued, especially on a comparative basis.
- We would be cautious about long-term government bond markets in the core Euroarea and in the U.S. and the U.K. this year. On the other hand, Irish 10-year government bond yields at around 9% look a tempting proposition but do carry a higher risk of default.
- Deposit rates will likely remain broadly unchanged in 2011 but the actual rates on offer will vary from institution to institution.
- Commodities should continue to perform strongly over the next 12 months, underpinned by continued strong emerging market demand and easy policy conditions in the West.
- Irish commercial property values are expected to continue to drift lower due to weakening rental values (yields should remain broadly stable). However, the market appears to be close to its cyclical bottom and looks attractively valued. U.K. and core Euroarea markets will continue to see strong investor interest for prime secure properties but non prime property values will remain under pressure.
- In general, investors and savers need to guard against the risk of rising inflation and a greater allocation to real financial assets is warranted.
- There are a number of obvious risks facing the markets in 2011 and these include:
  - Higher inflation
  - Sovereign risk contagion
  - Political flare-ups in Asia, especially the North-South Korea stand-off.

Introduction

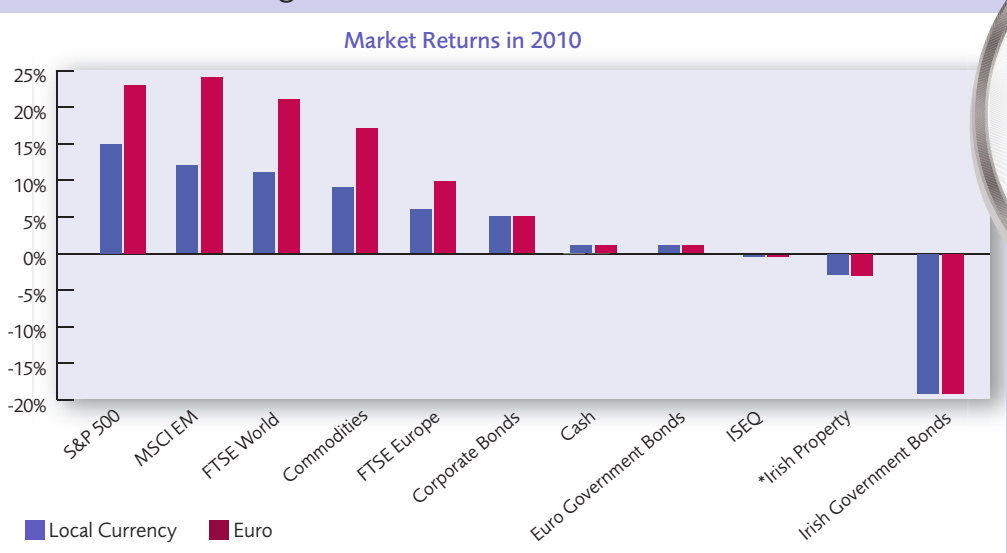
Positive for riskier assets in 2011

Another year, another crisis! Surely the Chinese philosopher who coined the phrase, "may you live in interesting times" didn't have Ireland in 2010 in mind. Ireland and the wider Euroarea sovereign debt crisis dominated the financial markets for much of 2010.

- Global equities in general performed quite strongly (with the notable exception of the Euroarea equity market).
- Irish commercial property drifted lower again last year, but U.K. and Euroarea markets performed strongly.
- Commodities had another solid year in 2010.
- Core government bond markets performed reasonably, as did corporate bond markets.
- Euroarea peripheral bond markets endured a rough year.

Global Assets

Total returns in 2010 – global asset markets



Source: Factset ** Irish Life Estimate*

...investors and savers should look at the amount of cash and deposits they have in their portfolios, as the re-emergence of inflation will erode the purchasing power of their money over time...

Rising commodity prices a prelude to higher inflation?

Outside of Ireland and the European sovereign debt crisis, another key theme was the strength of certain commodity prices last year, in particular agricultural commodity prices. While higher food prices do not sound like good news for most, farmers have been the unheralded success story of 2010. As an aside, farmers' incomes in Ireland and across Europe have increased significantly over the last 12 months, increasing by 46% in Ireland and 66% in France.

The key risk – higher inflation

A key risk over the coming years is higher inflation and a key source of inflation comes from rising commodity prices. The risk of higher inflation is compounded by the very expansionary monetary and fiscal policies in place in many of the major developed economies.

- We see inflationary risks mounting and would argue against investors being overly exposed to the long-term government bonds of the core Euroarea countries, the U.S. and the U.K.
- Similarly, investors and savers should look at the amount of cash and deposits they have in their portfolios, as the re-emergence of inflation will erode the purchasing power of their money over time.

Equity Snapshot

equities to perform strongly in 2011

2010 - Global equities – strong performance in the latter half of the year

- Global equities increased by 10.7% in local currency terms and 20.6% in euro terms.
- The key drivers were a strong U.S. stock market performance and growth in emerging markets.
- The Irish stock market performed poorly falling by 0.08%, while the Euroarea market performed modestly better registering growth of 3.2%.

Company earnings continued to surprise on the positive side and economic data was better than expected in the U.S. and Germany. The improvement has been driven by increased cost cutting as well as double digit revenue growth from companies that have exposure to emerging markets. These measures have offset the sluggish low single digit revenue growth that has been a feature of the developed economies.

Emerging equity markets saw strong money inflows as the outlook for the emerging economies continued to improve and investors sought to get exposure to companies, government bonds and the currencies of these regions.

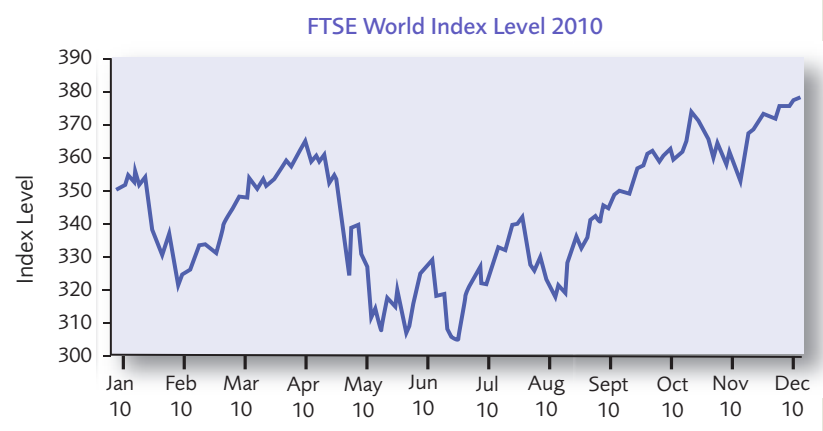
Stock market total returns 2010

	FTSE All Word	S&P 500	ISEQ	FT Eurobloc	FT Japan
Local Currency	10.7%	15.1%	-0.08%	3.2%	0.5%
EUR	20.6%	23.1%	-0.08%	3.2%	23.4%

Source: Factset

Equities

Global equity market performance in 2010



Source: Bloomberg

...continued strong earnings, supportive valuations and robust corporate balance sheets are likely to support equity markets during 2011...

OUTLOOK 2011

Equity market outlook positive

- Global equity markets are expected to perform in line with high single digit earnings growth in 2011.
- Quality blue chip companies look good value.
- European equity markets look fairly valued.

Given current valuations and the relative underperformance of quality blue chip companies, we believe that this sector of the market has the ability to perform reasonably well in the coming 12-months.

Going into 2011, it is hard to believe that the sovereign concerns that started in 2010 are going to dissipate significantly. This, combined with the threat of further downgrades by the rating agencies will lead to continued volatility for both bond and equity markets. Despite this, continued strong earnings, supportive valuations and robust corporate balance sheets are likely to support equity markets during 2011.

Bond Snapshot

bonds not the place to be this year

2010 Bonds – some good, some bad

- Core Euroarea, U.S. and U.K. government bond markets performed strongly last year.
- Peripheral government bond markets suffered.
- Ireland suffered with 10 year yields rising to 9%.
- Corporate bonds performed well in 2010.

Given the well documented concerns over the solvency of peripheral European governments and the lack of any overarching plan to address these issues, it is no surprise that investors flocked to safety. While the Merrill Lynch 5-10 year German government bond index rose by 6.5%, the Irish equivalent fell by 19.2%.

Corporate bonds also produced a strong performance with large European company corporate bonds returning 6.1%. This was driven by strong corporate earnings, an improving German economy and a shift from (newly) lower rated government bonds into corporate bonds.

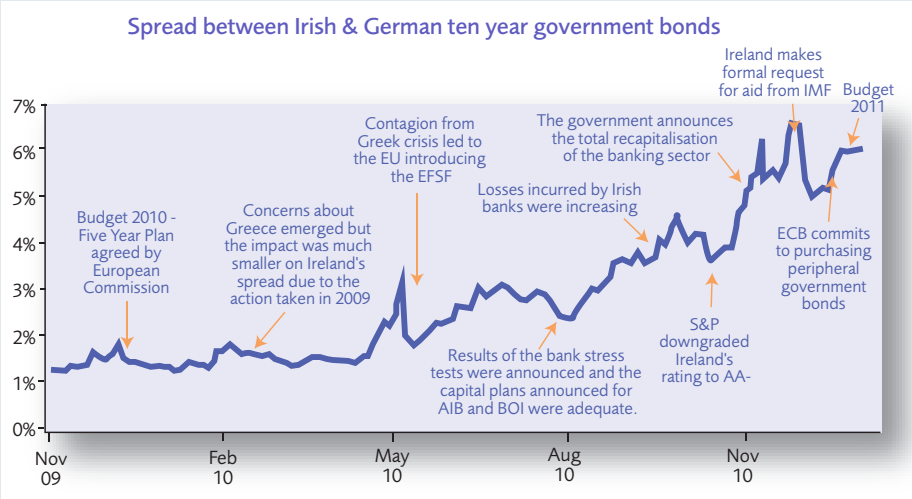
Bond market total returns 2010 (5-10 yr bond indices)

	EMU Govts.	Ireland	Germany	U.S.	EMU Corporates
Local Currency	0.2%	-19.2%	6.5%	8.6%	6.1%
EUR	0.2%	-19.2%	6.5%	16.2%	6.1%

Source: Bloomberg, Merrill Lynch indices

Irish Government Bonds

Irish government bonds underperformed dramatically in 2010



Source: Factset

...with long-term bond yields in Germany, the U.S. and the U.K. in the region of 2.8% to 3.5%, we would warn against having an overweight position in long-term government bonds as they are now a much riskier investment...

- Long-term bond yields in Germany, the U.S. and the U.K. are expected to rise in 2011, which will result in a fall in capital values.
- The prospect of higher inflation will also put further pressure on yields.
- Irish 10-year bonds are yielding in the region of 9% and look attractive, but investment markets are pricing in a 35% chance of default.

Generally the role of government bonds in a portfolio is to provide an anchor in terms of risk and diversification. With long-term bond yields in Germany, the U.S. and the U.K. in the region of 2.8% to 3.5% as of time of writing, we would warn against having an overweight position in long-term government bonds as they are now a much riskier investment.

Irish 10-year yields are in the region of 9% and if you believe that Ireland will not default on its sovereign debt, then these bonds make excellent investments.

Property Snapshot

commercial property returns supported by rental income

2010 commercial property – any light, any tunnel!

- Irish commercial property total returns are estimated to have fallen by 3% last year.
- U.K. market performed strongly in 2010.
- Prime assets in Western Europe rebounded strongly last year.

The Irish commercial property market has fallen by 60% from its peak in 2007, its biggest ever decline since records began. While commercial property prices can be expected to see some further weakening in the months ahead, it does appear that the Irish property cycle may be close to bottoming. The Irish market fell by approximately 3% in 2010.

Attractive yields on U.K. commercial property enticed investors, especially in comparison to the low yields available on U.K. government bonds (gilts). Since the trough of the market in July '09, capital values have rallied by c.16% (6.5% in 2010), driving total returns of 13% for the year.

In the Euroarea, a return to economic growth in the first half of last year and historic low bond yields led to a rebound in property prices in 2010, with investor interest concentrated on prime assets.

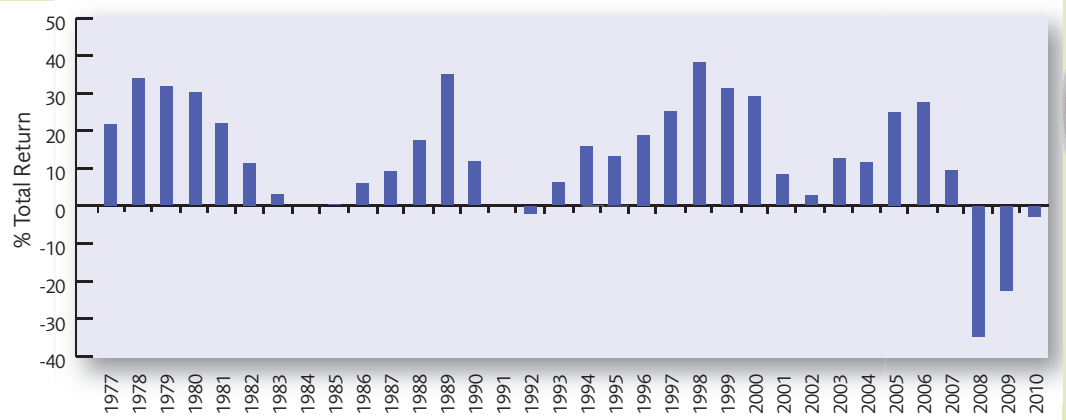
Commercial property returns

	2006	2007	2008	2009	2010
Ireland	27.2%	9.9%	-36.0%	-23.0%	-3.0%*
U.K. (Stg.)	18.1%	-3.4%	-22.1%	3.5%	14.5%

*Source: Factset, *Irish Life estimate*

Commercial property

Irish commercial property total returns 1977-2010



Source: IPD, (2010, Irish Life estimate)

...Irish commercial property market is close to its cyclical bottom and with yields in the region of 8% offers good value in our view...

OUTLOOK 2011

Irish property yields attractive

- Commercial property in Ireland looks attractive.
- U.K. commercial property market returns to be driven by income (rental) returns in 2011.
- Core-Euroarea markets expected to post strong returns this year.

We believe that the Irish commercial property market is close to its cyclical bottom and with yields in the region of 8% offers good value. We are unlikely to see any significant capital appreciation in the immediate future and thus returns will be determined by the yield and rental income from the underlying properties. The U.K. and Euroarea markets should post positive returns in 2011, but probably not at the same pace that occurred last year, with much of the positive performance concentrated in core prime assets.

Commodity Snapshot

commodities to benefit from strong global growth

2010 Commodities – rising prices a prelude to wider inflation?

- Commodities had another strong year in 2010.
- Top performing commodities were concentrated in the agricultural sector.
- Gold increased by nearly 30% last year.

Commodities returned 9% in 2010 (in dollar terms), according to the S&P GSCI index. Of the 24 individual commodities contained in the index, only three declined in 2010 namely cocoa, zinc and natural gas.

All the other commodities were in positive territory with the top performing commodity being cotton, which was up 106% in 2010. Other crops such as wheat and corn also experienced very strong gains on the back of poor weather last summer.

Oil prices remained broadly unchanged on the year, however gas prices fell significantly. Gold continued its stunning level of growth increasing by nearly 30% last year as investors concern over inflation led to increased demand.

GSCI commodity indices total returns 2010

	All	Energy	Industrial Metals	Agriculture	Gold
Local Currency	9.02%	1.91%	16.73%	34.19%	29.53%
EUR	16.89%	9.26%	25.15%	43.88%	38.87%

Source: Bloomberg

Commodity Index

Commodities started to rumble in 2010

Source: Bloomberg

...many commentators believe that the long-term outlook for commodities remains very positive and that commodities are in a structural bull market...

- Commodities expected to perform strongly this year.
- Concerns that rising commodity prices will lead to increased inflationary pressures.
- As investor interest increases, the diversification benefits of commodities might lessen.

Many commentators believe that the long-term outlook for commodities remains positive and that commodities are in a structural bull market. Also, commodities have been seen as a great diversifier in a traditional portfolio of equities and bonds and this certainly was the case up until recent years. However, as commodities become more of a mainstream investment, there is the risk that the correlation between commodities and equities will start to increase and thus undermine their diversification benefits. This is a risk that needs to be watched closely, as the fervour for commodities is unlikely to dim any time soon.

Cash Snapshot

cash returns won't match real asset returns in 2011

2010 Cash – the asset class of choice for Irish investors

- Irish retail investors flocked to cash in 2010.
- The household savings ratio is one of the highest in Europe.
- Net household savings running at in excess of €11 billion at the end 2009.

With the increased level of uncertainty in the domestic economy, cash funds and deposits – once the choice of the conservative investor – have become a more attractive investment option for a broad spectrum of investors. Deposit rates can vary quite significantly from one institution to another in the Irish market and looking at the rate on 6 month deposit accounts for example, it ranged from as low as 0.5% to as high as 2.85% at the end of last year. However, it is not the actual rate of interest that has driven the demand for deposits by Irish investors and savers, but rather a desire for safety.

...it is expected that there will be no change in ECB interest rates anytime soon and it is likely that it will be the start of 2012 before any rate hikes are introduced...

Irish households have exhibited very conservative saving and spending habits over the last couple of years. Net savings of households increased from €3.6bn in 2008 to over €11bn in 2009. The household net saving ratio increased from 3.9% in 2008 to 12.3% in 2009, with this trend likely to have continued in 2010.

SIF – Euro deposit rates at end December 2010

	PTSB	EBS	Rabo	BOI	AIB	Anglo	KBC	Investec
On Demand	-	-	2.00	-	-	-	-	-
1 month	1.85	1.80	0.20	0.77	1.20	0.81	1.20	-
3 month	2.60	2.50	0.35	1.13	1.40	1.02	1.40	2.75
6 month	2.85	2.85	0.50	1.36	1.60	1.26	1.63	2.75
7 month	3.20	-	-	-	-	-	-	-
9 month	2.75	3.40	-	-	1.75	1.40	1.77	2.50
11 month	3.35	-	-	-	-	-	-	-
12 month	3.40	3.50	0.80	-	1.90	1.53	1.91	2.50
15 month	-	4.40 (3.55 AER)	-	-	-	-	-	-
18 month	4.50 (2.98 AER)	5.00 (3.36 AER)	-	-	-	-	-	-
3 year	9.00 (2.91 AER)	-	-	-	-	-	-	-
5 year	20.00 (3.71 AER)	-	-	-				

Source: Irish Life

OUTLOOK 2011

Inflation on the prowl

- ECB to keep official rates unchanged until the start of 2012.
- Deposit rates unlikely to match the performance of risky assets in 2011.
- Nevertheless, Irish investors still likely to favour cash.

The European Central Bank has continued to leave interest rates unchanged at 1% for a record 19 consecutive months to December 2010 and it is expected that rates will be left unchanged until at least the start of 2012. Deposit and cash fund rates are unlikely to match the performance of risk assets this year, but Irish investors will still likely favour safety over returns. However, with rising inflationary pressures on the horizon, such a decision will likely prove costly in time.

Ireland Infocus

export sector key to economic growth

Continuing to face the challenges ahead

As Ireland faces into its fourth year of economic uncertainty, the challenges for the economy, banking sector and government are still considerable despite the very difficult measures that have been taken to date. However, economic statistics in the latter half of 2010 pointed to a stabilisation in the economy. Nevertheless, sentiment, media reports and commentary remains very much depressed. Ireland is now very much paying for the excesses of the boom time and has to undergo major structural reform to put the economy back on a sound and sustainable footing. The areas to be addressed are competitiveness, the public sector and the banking sector. It is expected that the Irish economy will grow by 1.0% this year, with stronger growth rates expected thereafter.

...it is expected that the Irish economy will grow by 1% this year, with stronger growth rates expected thereafter...

Economic indicators pointing towards stabilisation

Irish GDP increased by 0.5% in the third quarter as strong growth in net exports compensated for the weakness in the domestic economy, which continued to contract. Business confidence in the manufacturing sector pointed to continued expansion, the live register posted three consecutive months of decline since September, until the December release which saw an increase and the sharp decline in retail sales appears to have levelled off in the latter part of 2010. These indicators are supportive of Irish economic activity levelling out; however there is little evidence that the economy will rebound strongly in 2011.

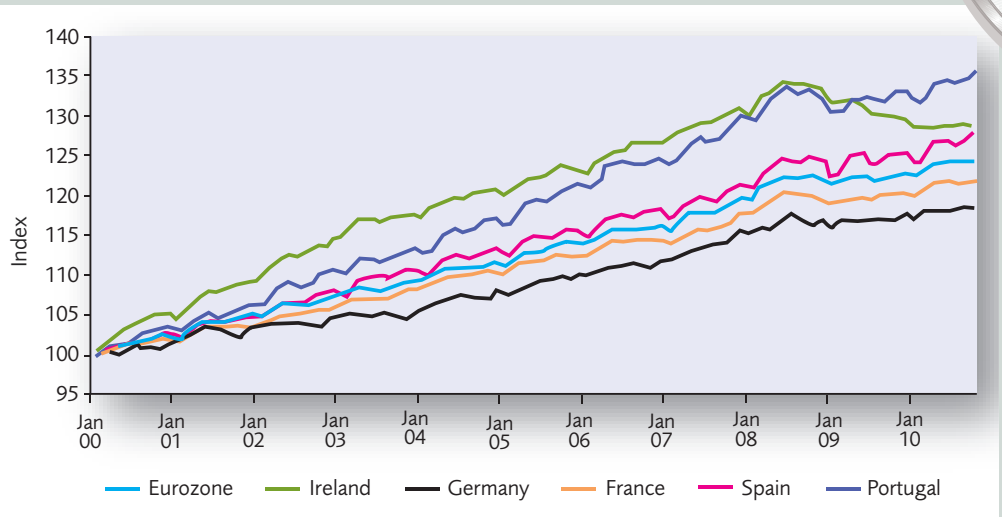
Competitiveness – some work done but plenty more to do

From 2000 to 2008, the rate of growth of consumer prices in Ireland was the highest in the Euroarea, so much so that the Harmonised Index of Consumer Prices (HICP) had increased 34% during that time, compared with a 22% increase in the Euroarea and 17% increase in Germany. Since the middle of 2008, consumer prices have been falling, resulting in an improvement in competitiveness, particularly as Ireland has been the only country in the Euroarea to experience a decline in prices as can be seen from the chart below.

... economic indicators are supportive of Irish economic activity levelling out; however there is little evidence that the economy will rebound strongly in 2011...

Consumer Prices

Irish consumer prices have fallen in recent years
Harmonised Index of Consumer Prices



Source: Factset

Competitiveness (cont'd)

The National Competitiveness Council noted in its latest annual report that international "competitiveness has improved significantly, skills availability has improved" but "considerable competitiveness challenges remain". As exports will be the key sector in delivering growth over the next couple of years, continued improvement in Ireland's terms of trade will be critical.

...currently the Irish government is spending €18bn more a year than it receives in tax receipts... this is not a sustainable situation for any government

Fiscal Challenges – undoing the policy mistakes of the previous decade

Currently the Irish government is spending €18bn more a year than it receives in tax receipts and therefore has to borrow this money to pay for public services. It has been well acknowledged that this is not a sustainable situation for any government and as a result the Irish government has made an adjustment of €14.5bn from 2008 to 2010 and plans on making a further €15bn adjustment from 2011 to 2014. This mammoth task for the country represents about 18% of GDP.

Episodes of large fiscal adjustments have taken place before. Bank of America Merrill Lynch has estimated that between 1970 and 2008 there have been 112 episodes of large fiscal adjustments, including the Irish adjustment from 1987-1989. In examining these episodes BoA Merrill Lynch found that large fiscal adjustments did not always result in a prolonged economic recession. The key features for economic success after fiscal adjustments are that the cuts would be based on current spending and be accompanied by income tax increases. They also noted that the adjustment is less damaging to the economy if it is swift and sizable and accompanied by lax monetary policy. The adjustments were also generally accompanied by a depreciation in the local currency – an option not within the control of the Irish government. However, an improved competitive position would help in this regard.

...however, the (fiscal) adjustments were also generally accompanied by a depreciation in the local currency – an option not within the control of the Irish government...

The government's National Recovery Plan is broadly in line with these features for the most part. However the government has cut its capital spending programmes, which is damaging to economic growth.

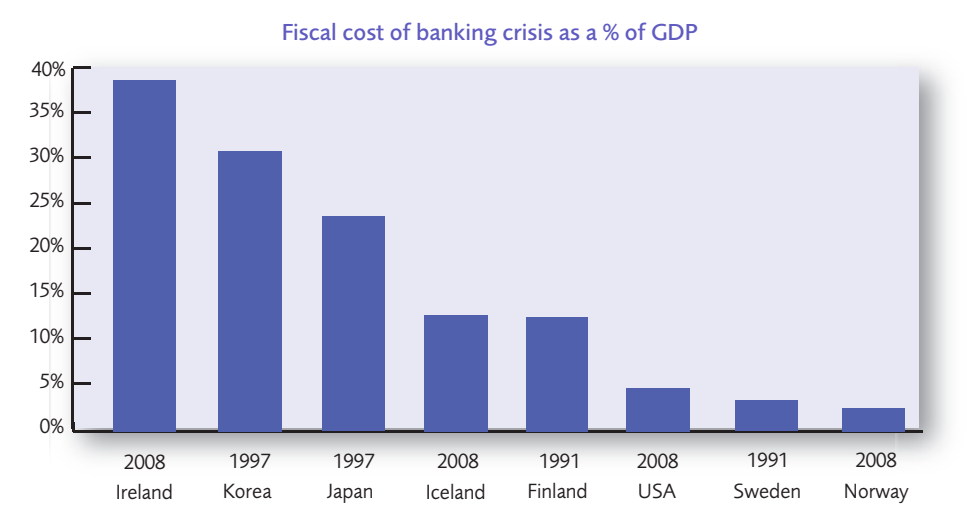
And what about the banks....

The crisis in the Irish banking sector is both a liquidity problem and a solvency problem and is no doubt the biggest challenge facing Ireland. Currently the losses are expected to cost the state as much as 38% of GDP or €60bn. This crisis is often compared to other banking crises such as Finland or Sweden, however as can be seen from the chart opposite, the fiscal cost of the Irish banking crisis as a percentage of GDP has been far greater than seen in other banking crises. The steps taken by policy makers to date in the creation of NAMA and recapitalising the banks have failed to provide sufficient credit to the economy. A key policy objective will be to ensure that the Irish banking sector can function normally again, so as to underpin any prospective recovery in the economy.

...the crisis in the Irish banking sector is both a liquidity problem and a solvency problem and is no doubt the biggest challenge facing Ireland...

Banking crisis costs

The banking crisis - particularly expensive for Ireland



Source: Goodbody Stockbrokers, IMF & Irish LIfe

...Ireland is fundamentally different from other peripherals (countries) because it is a fully deregulated, fully liberalised, flexible market economy. Hence, it should be able to adjust to the new post-crisis world more swiftly...

Ireland 2011 & beyond…

The outlook for the domestic economy going into 2011 remains clouded as the necessary rebalancing and restructuring of the economy continues. The adjustments to competitiveness, the government finances and the banking system are necessary to ensure that the economy can recover meaningfully in the years ahead. In 2011 the weakness in the domestic economy is likely to be offset by strength in the export sector, particularly since the global recovery is on track. A weaker euro would also be a huge help in this regard.

To end on a positive note, according to Morgan Stanley, "Ireland is fundamentally different from other peripherals (countries) because it is a fully deregulated, fully liberalised, flexible market economy. Hence, it should be able to adjust to the new post-crisis world more swiftly."

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dollar
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Irish Life

Irish Life

Our strength, your security

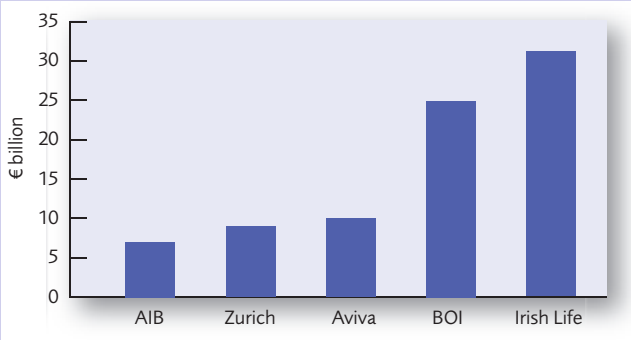
Irish Life is Ireland's biggest life and pension company and has been helping Irish people manage their finances since 1939. Over more than 70 years we've proven that we can help protect what is important to our customers through good times and bad.

Safety in real numbers

- Over 700,000 personal customers now rely on our products and services to help them secure their futures. We also have 200,000 people who have company pension schemes with us through their employers.
- Over the last 5 years we have paid out over €1bn in protection benefits to over 30,000 Irish families.
- 8 of the 10 biggest Irish companies have pensions with us and 6 out the 10 biggest US companies choose Irish Life for their Irish employees' pensions.
- Irish Life Investment Managers (ILIM) is Ireland's number 1 investment manager when it comes to the amount of money managed for Irish people. Overall, ILIM manages more than €31 billion.

Irish Assets

Irish assets under management



Source: Irish Association of Investment Managers

This table shows the assets under management at the end of 2009 for the investment managers of each company.

Financial security of life companies

Irish Life is a secure, well capitalised, low risk company. We operate a low risk business model, with a range of safeguards in place to protect our customers. In addition, as a life insurance company, we have many layers of protection to give our customers financial security, three of which are: unit-linked funds, ring-fenced assets and capital reserves.

1: Unit-linked funds

Customer's money is usually invested in unit-linked funds. They buy units in a fund and the life company is required to hold all the assets underlying its unit-linked policies (plus an additional amount for 'solvency margin' as described below). A key difference between a life company and a bank is that a bank is not required to hold the full amount of its deposits as liquid assets. As a result, there is no equivalent to a 'run on a bank' for a life company since an insurer will hold matching assets at all times. If the value of assets increases, then the liabilities go up and, if the value of assets decreases then the liabilities decrease as well. Irish Life held €24bn in assets to back unit-linked liabilities at 30 September 2010.

2: Ring-fenced assets

Life companies must be self-sufficient – their assets must be separate from any parent or other group company. So, in the unlikely event of the insolvency of a parent or holding company, the creditors of the parent / holding company would have no call on the assets of the life company. In the case of Irish Life, our assets are separate from those of permanent tsb and the assets of Irish Life cannot be transferred to other parts of the group. We are also independently regulated.

3: Capital reserves

Under EU regulations, in addition to holding all the assets underlying their policies, life companies must hold additional reserves on top of this. This is called 'solvency margin' and gives an additional layer of protection for customers. The Central Bank of Ireland requires companies to hold a further 50% of reserves. So Irish Life must have:

Assets to fully match customer liabilities
PLUS
EU solvency reserves
PLUS
50% extra reserves under Irish regulation

In summary – Irish Life strength in numbers

As an Irish company we are totally focussed on meeting the needs of Irish people. Irish Life's financial strength and our strong level of reserves should reassure all our clients and allay any of their worries given the current difficult period for the Irish economy. We've proven over the years that we'll be here for our customers even when times are tough.

Irish Life's

Spotlight on our flagship funds and some of our satellite funds

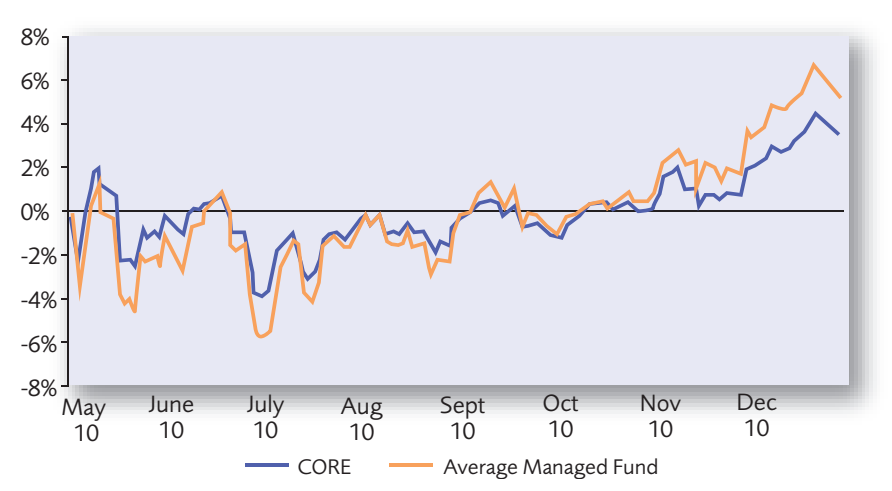
CORE, Protected Consensus Markets and Consensus are Irish Life Retail's flagship funds that offer choice for investors and advisers across different risk categories. These flagship funds are ideally suited as either stand alone investments or to form the anchor of a wider portfolio.

CORE

CORE invests in traditional assets such as equities, bonds, property and cash. It also includes a greater mix of alternative investments than the average managed fund. This gives investors a more diversified fund with lower volatility, while aiming to achieve returns similar to the average managed fund. On our risk scale of 1 to 7, CORE ranks as 4. The performance of CORE since its launch in May has achieved these twin goals as this chart shows clearly. It should be noted that this is a short time frame to judge performance.

CORE Performance

Average managed fund versus CORE since launch



Source: Moneymate

Consensus Fund

The Consensus fund is one of the largest managed funds in the Irish market. It's aim is to replicate the average asset allocation of the Irish fund management industry and give performance in line with the average of all managed funds in Ireland. The Consensus fund performed strongly in 2010, rising by 12%. The three and five year annualised returns are -4.10% and -0.75% respectively.

Protected Consensus Markets Fund

The Protected Consensus Markets Fund (PCMF) is a medium risk fund that follows a dynamic asset allocation process where assets are invested in a mix of the Consensus Markets Fund and the Protected Fund. This mix changes depending on market conditions. A large part of the investment is protected by using the protected price pledge which aims to prevent the unit price of the fund from falling below 80% of its highest value. On our risk scale of 1 to 7, PCMF ranks as 3. Since launch in September, PCMF has performed very well and is up 4.9% to the end of December.

Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up. Funds may be affected by changes in currency rates.

Staying InFocus

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